

Investing Drives Capitalism Reform

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Global Leadership in the 21st Century

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The need for systemic solutions to climate change and other global challenges is becoming obvious and mainstream. At the 2020 Davos meeting of the World Economic Forum (WEF), business and political leaders agreed to promote stakeholder capitalism as a way to address major problems. Klaus Schwab, WEF Founder, discussed the need for global system change. Larry Fink, CEO of Blackrock the world's largest asset manager, recently announced that environmental sustainability would be a core goal of investment decisions. He previously said that businesses must shift their focus from narrowly benefiting shareholders to broadly benefiting all stakeholders and society. Jeff Bezos, CEO of Amazon, recently announced that the company would work with its supply chain to address climate change. Amazon announced aggressive goals, including achieving the Paris climate agreement objectives ten years early and using 100 percent renewable energy by 2030. The Embankment Project of the Coalition for Inclusive Capitalism promotes long-term investing and includes Blackrock, Allianz, Vanguard and other leading asset managers.

Developing and implementing systemic solutions requires effective global, national and organizational leadership. A joint project of the United Nations and the World Academy of Art & Science (WAAS), Global Leadership in the 21st Century (GL21), seeks to clarify and promote this. GL21 defines leadership more broadly than the qualities of individual leaders. It is the overall process by which society progresses and resolves major challenges. Aspects include unifying visions, coordinated multi-stakeholder action, enhanced institutional effectiveness, and inspiring individual leaders.

Established in 1960 by leading scientists, WAAS promotes whole system, interdisciplinary strategies for advancing humanity. Extensive beneficial work is being done to address climate change and other major problems. But in spite of this, environmental, social and economic conditions are declining rapidly in many areas. Clearly new approaches are needed. GL21 seeks to foster and accelerate the development of the new leadership and strategies required for effectively addressing global challenges. Humanity has achieved many cultural, ethical and structural advances. Aspects of these past successes are explored and integrated when relevant and useful for new strategies.

This article summarizes how a successful investment approach can be modified in ways that drive systemic solutions. Environmental, social and governance research (ESG) and Sustainable/Responsible Investing (SRI) successfully encouraged nearly all large companies to implement sustainability strategies. The focus of ESG-SRI largely is on changing companies and addressing environmental, social and economic problems (symptoms). A new investment approach, System Change Investing (SCI), shifts the focus to system change and root causes. It recognizes that companies largely are controlled by overarching economic and political systems. These systems, including capitalism and democracy, provide many benefits to society. But they also unintentionally incentivize harmful behavior.

Very generally speaking, companies can voluntarily mitigate about 20 percent of short-term and long-term, tangible and intangible, negative environmental and social impacts in a profit-neutral or profit-enhancing manner. Beyond this point, costs usually go up. If companies continue eliminating negative impacts, they will put themselves out of business long before reaching full impact mitigation. Flawed systems unintentionally put business in conflict with society and humanity in conflict with nature. They

do this mainly by not enforcing the rule of law. This principle says that individuals and companies should be free to do what they want, provided that they do not harm others.

Flawed systems fail to hold companies fully responsible (violate the rule of law) through many specific mechanisms, including limited liability, time value of money and externalities. This often makes it impossible for businesses to fully mitigate impacts in competitive markets and remain in business. These reductionistic systems are the root causes of the major challenges addressed by the UN Sustainable Development Goals (SDGs). Improving them is the most important action needed to achieve the goals.

The corporate and financial sectors are among the most powerful segments of society. They largely are controlled by investing. SCI uses this powerful lever to drive capitalism reform and other systemic solutions to major challenges.

Sustainable/Responsible Investing

Until the 1990s, nearly all SRI was done through ethical or negative screening. This involves avoiding sectors to which one is ethically opposed, such as armaments, gambling, alcohol, tobacco, nuclear power and coal-fired electricity. Avoiding sectors can reduce portfolio diversity, increase risk and lower returns. However, the approach also can reduce risk by avoiding high risk sectors. Negative screening is still widely used today.

In the 1990s, a new SRI approach (positive screening) was introduced. This involves remaining in sectors and shifting investments to sustainability leaders. Positive screening frequently provides greater financial and sustainability benefits than negative screening. The approach enhances returns by integrating financially relevant ESG risks and opportunities that typically are not addressed by traditional financial analysis and by providing a strong indicator of management quality, the primary determinant of stock market performance. Sustainability is a complex management challenge, involving many stakeholders, intangibles and complex issues. Sustainability leaders implicitly have the sophistication needed to excel in other business areas, and thereby earn superior investment returns.

Innovest Strategic Value Advisers, the largest ESG research firm before it was purchased by MSCI in 2010, helped to pioneer positive screening by providing best-in-class ESG ratings. In nearly all sectors, sustainability leaders, taken as a group, outperformed laggards by 300 to 3000 basis points per year.

Positive screening can provide greater sustainability benefits than negative screening because it more effectively engages companies and sectors. With negative screening, investors have little or no influence over excluded sectors. There is little excluded companies can do to access this type of capital, short of abandoning harmful sectors, which might be their whole business. Positive screening, on the other hand, can engage entire sectors. Sustainability leaders seek to protect their access to capital by maintaining superior performance. Sustainability laggards often strive to improve performance, and thereby access SRI funds.

Twenty years ago, the prevailing financial community wisdom was that SRI violated the fiduciary obligation to maximize returns by taking nonfinancial issues (ESG factors) into account. However, these factors are increasingly financially relevant. Taking care of employees, making safe products, reducing energy costs and many other ESG actions can provide financial and competitive benefits. As this became clear, fiduciary concepts began to change. Newer views recognized that ignoring financially relevant ESG factors violates the fiduciary obligation to maximize returns, as ignoring any other financially relevant factor would.

Initially, asset managers often purchased ratings from ESG research providers and used them to develop positive screened, best-in-class funds. However, as financial analysts better understood ESG issues, they frequently purchased the ESG data underlying ratings, and then integrated it with financial analysis based on their unique financial and sustainability objectives. This process is called ESG integration. It is the same as positive screening in the sense that ESG data is being used to enhance financial and sustainability performance.

Whole System Solutions

SCI is based on the famous Einstein adage that we must think at a higher level to solve our most complex challenges. Human society reflects human thinking. Every major challenge facing humanity ultimately results from the way we think of ourselves and the world. In reality, all major aspects of society are connected (environmental, social, economic, political, psychological, spiritual, religious). But considering the interconnected whole system at once is difficult. As a result, we frequently address parts of society in isolation. This reductionism ignores relevant factors and produces unintended consequences. Our myopic economic and political systems compel all companies to harm the environment and society. Obviously, no one intended this.

Reductionism pervades all areas of society, including SRI, corporate sustainability strategies and the sustainability movement in general. Nearly all corporate sustainability and SRI strategies are focused on changing companies instead of the systems that control them and compel their harmful behavior. These movements also largely are focused on symptoms (environmental, social, economic problems), instead of root causes (flawed systems). The higher level thinking advocated by Einstein involves moving out of illusion (reductionism) and into reality (whole system, integrated thinking). This reality-based thinking is the foundational solution for achieving the SDGs and sustainability.

At the detail level, considering all physical and nonphysical (consciousness) aspects of society at once is highly complex. Focusing on the many local and global challenges facing humanity, such as those addressed by the SDGs, is like viewing waves on the ocean. It seems impossible to consider everything at once. However, at the big picture level, whole system thinking greatly simplifies and clarifies the path to sustainable society.

Whole system thinking focuses on the systemic forces creating the waves and problems. It illuminates that there is only one foundational solution needed – reality-based thinking and the new systems and actions that result from it. In reality, we are all parts of one interconnected system. No individual, company or country can survive and prosper apart from this system. Nature implicitly operates from a whole system perspective. All aspects are balanced and taken into account. Nature produces nearly infinite levels of coordination, sophistication, efficiency, resilience, technology and sustainability. As parts of nature, we have the innate ability to produce the same high levels. We can be nearly infinitely more prosperous than we are now.

Nature models the higher level, interconnected, whole system solutions needed to resolve major challenges. Translating these higher-level ideas into compelling, actionable solutions that meet people and organizations where they are now is essential. SCI is based on this approach.

System Change Investing

SCI represents a major opportunity for the financial community and broader society. It is a powerful, actionable, truly new paradigm approach to investing. New paradigm: it largely switches the focus from company change and symptoms to system change and root causes. Powerful: it uses investing (one of the most powerful levers in society) to drive system change (the most important action needed to achieve the

SDGs and sustainability). Actionable: SCI is practical and easily implemented because it is based on a proven approach (SRI) that nearly all large financial institutions already are doing.

SCI drives new corporate behavior in exactly the same way that SRI has successfully done for over 20 years. As the owners of companies (investors) took corporate sustainability (ESG) performance into account when making investment decisions, companies were compelled to implement sustainability strategies. As investors take corporate system change performance into account, companies will be compelled to engage in this area.

There have been many efforts to standardize ESG metrics. The same will occur with system change metrics. Rating companies on system change performance is far more complex than ESG analysis. The frame of reference is much broader. ESG rating largely is focused on assessing corporate efforts to reduce negative impacts, for example, by lowering pollution and selling low impact products. The frame of reference for system change analysis ultimately is the whole Earth system and its sub-element human society.

System change in general must be understood before corporate system change performance can be accurately rated. This involves clarifying the characteristics of sustainable society, specific system changes needed to achieve it, and the actions in all areas of society required to bring about these changes. Once this system change roadmap or template is clear, the optimal corporate role in bringing about these changes and actions can be clarified and rated. The book *Global System Change: A Whole System Approach to Achieving Sustainability and Real Prosperity* (GSC) describes the system changes needed in all main areas of society to achieve the SDGs and sustainability.

There is not one ‘correct’ way to rate corporate system change performance, as there is not one correct ESG rating approach. There are many ways to rate this performance, ranging from simple models based on traditional corporate system change issues, such as campaign finance, lobbying and media campaigns, to full whole system approaches like that described above.

The first SCI model, Total Corporate Responsibility (TCR[®]), was developed in 2003. It is a true whole system approach based on three principles – interconnectedness (businesses are parts of larger systems), actualization (focusing on maximizing the well-being of society), and posterity (protecting future generations). The model is segregated into three broad metric categories – traditional ESG, mid-level system change (sector, stakeholder, environmental/social issue-level), and high-level system change (economic, political, social system-level). Sample metric categories include system change strategies, engagement in collaborative system change efforts, government influence activities, public awareness and media campaigns, addressing specific system flaws, and supporting system change organizations.

Implementing SCI requires providing a strong business case for system change, as was required for ESG-SRI. The business case for system change is strong and clear. Flawed systems compel companies to cause negative environmental and social impacts. As the human economy expands in the finite Earth system, these impacts return more quickly to harm businesses, often in the form of market rejection, lawsuits and reputation damage. Companies have strong financial incentives to reduce negative impacts. But they usually only can mitigate a small portion on their own before running up against systemic barriers, such as the requirement to maximize shareholder returns. System change is needed to mitigate the vast majority of negative corporate impacts. It is essential for protecting companies, investors and society.

The business case also involves clarifying the extensive asset manager benefits of launching SCI funds. These include enhanced investment returns, reputation and assets under management. SCI ratings identify financially relevant systemic risks and opportunities and provide an even stronger management quality indicator than ESG ratings (because system change is a more complex management challenge). SCI

ratings can be used as overlays to enhance the returns of many fund types, including value, growth and index.

The activities of the World Economic Forum, Blackrock, Amazon and many other organizations highlight the essential need for system change. To illustrate, climate change is receiving extensive mainstream attention. Nearly all efforts are focused on reducing greenhouse gas emissions. But this does not address the root cause of climate change. The root cause is flawed systems that compel companies to emit these gases. System change is the most important action needed to resolve climate change and all other major challenges. It is highly efficient because one solution (system change guided by whole system thinking) largely resolves all major environmental, social and economic problems. Sustainable systems make acting in a fully responsible manner (i.e. not harming the environment and society) the profit-maximizing strategy.

The global SRI market is over \$30 trillion. Many factors are causing this market to grow faster than traditional investments, including rising concerns about environmental and social degradation, increasing regulations and pension fund SRI requirements, superior SRI fund returns, and rapid growth of sustainable product markets. As awareness grows that system change is the most important sustainability issue, asset managers offering SCI funds will be seen as the new SRI leaders. SCI funds can provide greater sustainability benefits than symptom and company-focused SRI approaches. This will attract sustainable investors and enable asset managers to increase assets under management.

GSC and SCI provide true whole system approaches to achieving the SDGs and sustainability. The WEF recently issued a Global Risks Report. From a solutions perspective, a Global Root Causes Report is equally important. GSC provides extensive root cause and systemic solution information. At the Davos meeting, WEF highlighted 160 Lighthouse Initiatives that are providing excellent sustainability benefits. SCI represents another important strategy. Converting a substantial portion of the over \$30 trillion SRI market to SCI is the most powerful short-term driver of the most important action needed to achieve the SDGs – system change.

GL21 fosters the development of new, innovative approaches to resolving global challenges. SCI is the next logical evolution of SRI. It provides a practical way to engage the powerful corporate and financial sectors in systemic changes, including capitalism reform. Mainstream activity shows the timely nature of system change. The time is right to use investing to drive it.

Frank Dixon established Global System Change in 2005 when he recognized that system change would become the dominant sustainability issue of the 21st Century. His experience as the Managing Director of Research for the largest ESG research company (Innovest) and sustainability advisor to Walmart and other organizations showed that flawed economic and political systems compel all companies to degrade the environment and society. He conducted several years of multidisciplinary research to produce a true whole system approach to sustainability (described in the Global System Change books). The approach provides practical system change strategies for all major areas of society. In the corporate and financial sectors, System Change Investing represents the most advanced and effective sustainability strategy. Frank Dixon advises businesses, investors and governments on sustainability and system change. He has presented at many corporate and financial sector conferences around the world, as well as leading universities, including Harvard, Yale, Stanford, MIT and Cambridge. Frank Dixon is an Associate Fellow of the World Academy of Art and Science. He has an MBA from the Harvard Business School.

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